

Internal Revenue Service
memorandum

CC:TL-N-2293-90

Br4:KAAqui

date: JAN 17 1990

to: District Counsel, [REDACTED]

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Request for Tax Litigation Advice
[REDACTED]

By memorandum dated December 18, 1989, you forwarded a request for litigation advice in the above-referenced case and copies of documents provided by the taxpayer to support the claimed exclusion. For the reasons stated below, we continue to believe that the issue should be defended in cases where appellate venue is other than the Court of Appeals for the Third Circuit.

ISSUE

Whether liquidated damages awarded in settlement of an action brought under the Age Discrimination in Employment Act, 29 U.S.C. § 621 et seq. are excludible from gross income under I.R.C. § 104(a)(2) as damages received on account of personal injury.

FACTS

The facts as recited herein have been gleaned from the complaint filed by petitioner in the federal district court for the [REDACTED] against his former employer and the settlement agreement executed by the parties and other documents provided; this recitation does not purport to be all inclusive.

Petitioner in his complaint filed in the district court, alleged that he was employed by [REDACTED] as a Captain (pilot in command) prior to his termination shortly after his sixtieth birthday. Generally, each commercial aircraft employs three flight deck crewmembers -- captain, first officer (second in command) and flight engineer. The Federal Aviation Administration (FAA) promulgated a rule at 15 C.F.R. § 121.383(c) which prohibited persons over age sixty from serving as captain or first officer. [REDACTED] established a policy which prohibited persons over sixty who have served as captain from holding any position as a flight deck crewmember or as a non-flight

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crewmember. The termination of petitioner pursuant to [REDACTED]'s policy, it was alleged, constituted a wilful violation of the ADEA and as relief, petitioner sought inter alia, reinstatement, retroactive seniority rights and other benefits, back pay plus interest and liquidated damages.

Prior to trial, the parties executed a Release and Settlement whereby, for \$[REDACTED], petitioner agreed to release [REDACTED] from all claims arising out of his employment relationship whether or not said claims were asserted in the ADEA action. Of this sum \$[REDACTED] was described as "Non Liquidated" Gross Amount subject to withholding of tax and the remaining \$[REDACTED] was described as "Liquidated". Pursuant to the fee arrangement, petitioner's counsel retained \$[REDACTED].

On his tax return for [REDACTED], petitioner did not report the \$[REDACTED] received as liquidated damages and claimed the entire amount of the attorney fee as a deduction. By statutory notice of deficiency, the Service determined that the entire payment was subject to tax and that no deduction was allowable for the payment of attorney fees. 1/ In his answer, respondent generally denied the allegations for lack of knowledge or as a legal conclusion and by cover letter to opposing counsel asserted that even if the liquidated damages portion of the payment were excludable, only an allocable part of the attorney fees paid would be deductible.

ANALYSIS

Section 61(a) of the Code provides that, except as otherwise provided in the Code, gross income means "all income from whatever source derived." Accordingly, any funds or other accessions to wealth received by a taxpayer are presumed to be gross income, unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-431 (1955).

Section 104(a)(2) of the Code provides an exclusion for "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness."

Treas. Reg. § 1.104-1(c) provides that the term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a

1/ The Service also determined that petitioner failed to report as income \$[REDACTED] received from the [REDACTED] and the correctness of this determination was conceded in para. 5(d) of the petition.

legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Neither the statute itself, the regulations promulgated thereunder, nor the legislative history provide any guidance with respect to the meaning of the term "personal injuries." However, it is clear that the tax consequences of an award of damages depend on the nature of the litigation and on the origin and character of the claims adjudicated and/or settled. Church v. Commissioner, 80 T.C. 1104 (1983); Seay v. Commissioner, 58 T.C. 32 (1972). Where, as here, a plaintiff recovers damages due to discrimination but the trier of fact does not indicate the basis on which the award of damages was determined, then to ascertain the nature of the damages it is necessary to examine the allegations of the complaint, the evidence presented and the arguments made in the federal district court proceeding. Rev. Rul. 85-98, 1985-2 C.B. 51; Metzger v. Commissioner, 88 T.C. 834, 848 (1987); Threlkeld v. Commissioner, 87 T.C. 1294 (1986); Church v. Commissioner, 80 T.C. at 1107.

Notwithstanding our decision to withdraw our recommendation for appeal of the Tax Court's decision in Rickel v. Commissioner, 92 T.C. No. 32 (1989), the Service's position on this issue remains the same, *i.e.*, liquidated damages received in an ADEA action are punitive in nature and do not fall within the exclusion provided by section 104(a)(2), *i.e.*, damages are excluded under section 104(a)(2) only if they simply make the taxpayer whole. See Starrels v. Commissioner, 304 F.2d 574 (9th Cir. 1962). Our decision was based in large part on considerations of an unfavorable appellate venue and the existence of a more appropriate vehicle to litigate the taxability of punitive damages. See Miller v. Commissioner, 93 T.C. No. 29 (1989). These considerations are set forth in our letter dated October 2, 1989, to the Department of Justice withdrawing our appeal recommendation in Rickel. The underpinning of our position on the legal issue have been set forth in Rickel v. Commissioner, O.M. 20,177, CC:IT&A:TR-45-436-89 (July 14, 1989). Thus, instead of repeating them here, we attach copies for your information and for your use in potential litigation. We also attach for you use a copy of the Tax Division's recommendation for appeal in Miller.

Although the facts in Miller and Rickel are not identical, and the Tax Court "skirted the issue" in Rickel, we believe that the principle is substantially the same. In dissenting from the majority opinion in Miller, Judge Whalen noted that if the phrase "on account of" were to be construed as providing a causation test, none of the award received in Rickel would have been excludable. Based on state law, the dissent concluded that punitive damages do not serve a compensatory purpose but are awarded to punish and deter future wrongful conduct. We continue to believe that the Tax Court erred in focusing on the nature of

liquidated damages in the hands of the recipient rather than the purpose for which such damages were provided in the statute.

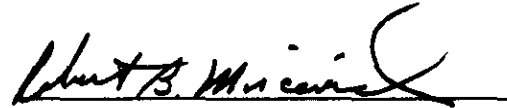
However, we do not anticipate an appellate opinion in Miller in the near future. Thus, while it appears that the Tax Court will hold adversely to respondent in the instant case, we do not believe that concession is appropriate notwithstanding the spectre of an award of litigation costs to petitioner. If an appeal of this case will be prosecuted to the Court of Appeals for the Seventh Circuit, an adequate record must be established in the Tax Court.

Please keep us apprised of any developments in this case and, if you have any questions or need further assistance, contact Mr. Keith A. Aqui at FTS 566-3308.

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By:



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Attachments:

O.M. 20,177

Ltr.dtd. 10-02-89

D.J. Memo. dtd. 11-17-89